

# **MINUTES OF THE CAPITAL PROJECTS AND BOND OVERSIGHT COMMITTEE**

**February 21, 1996**

The Capital Projects and Bond Oversight Committee met on Wednesday, February 21, 1996, at 12:30 p.m., in Room 125 of the Capitol Annex. Representative Robert Damron, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Representative Robert Damron, Chairman; Senators Charlie Borders and Jeff Green; Representatives Jim Maggard, Tommy Todd, and Jim Wayne.

Guests: Bill Hintze, Allen Holt, Governor's Office for Policy and Management; Secretary John McCarty, Deputy Secretary Rex Hunt, Karen Powell, Clark Beauchamp, Jim Abbott, Beth Hilliard, Ed Ross, Finance and Administration Cabinet; David MacKnight, Assistant Deputy Attorney General; John Cubine, Ray Franklin, Ron Burgess, and Robert Jones, Attorney General's Office; Mary Lassiter, Kim Blitch, Office of Financial Management and Economic Analysis; Ed Hatchett, State Auditor of Public Accounts; Jack Affeldt, Mike Greenwell, LRC.

LRC Staff: Mary Lynn Collins, Pat Ingram, Scott Varland, Esther Robison.

Chairman Damron said the Committee has devoted a lot of time to the Lexington World Trade and Cultural Center project over the years, and especially over the last 12 months. He said the Committee's goal for today's meeting was twofold. First, the Committee wanted to ensure that all possible steps are taken to determine whether there was any criminal wrongdoing relating to acquisition of the Ben Snyder block as the site for the Cultural Center; and second, the Committee wanted to see what the state can learn from this experience, and what changes should be made to prevent such problems in the

when its investigation into the acquisition was completed. He said several weeks ago he was informed that the AG's Office was nearing completion of its investigation, and he asked that the Office present its report at today's meeting. He said the deadline to request a bill draft was the following day, and if any statutory changes are recommended and endorsed by the Committee today, there will still be time to introduce a bill incorporating the changes.

Chairman Damron introduced David MacKnight, the Assistant Deputy Attorney General. Chairman Damron also recognized in the audience Secretary John McCarty of the Finance and Administration Cabinet, and Ed Hatchett, the new State Auditor.

Mr. MacKnight introduced John Cubine, the AG's Chief of Staff, and Ron Burgess, the Investigative Supervisor in the AG's Special Investigations Division, along with Ray Franklin, the Director of Special Investigations, and Robert Jones, a Chief Investigator in the Division. Mr. MacKnight said, at the request of the Lexington-Fayette Urban County Council, the Auditor's Office conducted an extensive review, from February to July 1995, of the Kentucky World Trade Center and Cultural Center projects. On July 25, representatives of the Auditor's Office presented the report to this Committee. He said the principal finding of the Auditor's report, based on a reappraisal by a nationally-recognized real estate appraiser, was that the City of Lexington and the state paid approximately \$3.5 million too much for the Ben Snyder block property. On August 15, this Committee asked the AG's Office to conduct an investigation of the matter. The AG's investigative field work was conducted, primarily by Mr. Burgess and Mr. Jones, from August 1995 through December 14, 1995. He said the investigators and attorneys in the AG's Office examined over 2,000 pages of records and interviewed current and former state and city officials, appraisers, and citizens having knowledge of the project. He said the investigations of both the Auditor's Office and the AG's Office were hindered by the fact that most of the events occurred between 5-9 years ago; memories had faded, some of the witnesses had become ill, some witnesses had died, documents had been discarded, and other documents had been lost.

Mr. MacKnight said the City of Lexington and the state purchased 90% of the Ben Snyder block from the Southcreek Lexington Properties Corporation. Half of the stock in this Corporation was owned by the Southcreek Properties

Mr. MacKnight said the Auditor's finding leads naturally to the question how could the City pay \$7.27 million when the national expert appraised the property at \$3.75 million. He said KRS 45A.045(8) requires the state, when purchasing real estate, to pay fair market value as determined by an appraisal. He said state regulations (200 KAR 5:021) require 2 appraisals when it appears that the property will be over \$100,000 in value, and those appraisals must be reviewed by the Division of Real Properties in the Finance Cabinet. He said there was also a Memorandum of Understanding (MOU) between the City of Lexington and the state that governed this transaction. The MOU referenced KRS Chapter 45A and also stated that the City would purchase any real estate according to the fair market value set by an appraisal.

Mr. MacKnight said, in the case of the Ben Snyder block, the City did obtain 2 appraisals and those appraisals were reviewed. However, one of the appraisals was disregarded because it was incomplete and included property not owned by the seller, and the City's purchase was based on the single remaining appraisal. He said that appraisal was reviewed in the standard review process by the Division of Real Properties; however, the review file that contains the documentation for that review is no longer in the Finance Cabinet's files, and it was not there when the Auditor's Office did its review. Therefore, in order to determine what happened during that review process, auditors and investigators from the AG's Office interviewed everyone who was connected to that review process and reviewed available records. Mr. MacKnight said it is not clear when the reviewer received the appraisals, how much time he spent on the appraisals, or how in-depth the review was. He said the reviewer was interviewed; he is now retired and the interview was limited due to his health problems. He said the reviewer stated he did not remember how much time he had to work on this review, and he did not know where the file is now; he indicated the file was there when he retired. Mr. MacKnight said representatives of the Finance Cabinet, former and current, have indicated to the Auditor's Office and the AG's Office that many Cabinet employees and other state employees had access to those files in the regular course of state business. Also, citizens reviewed the files under the Open Records Act.

Mr. MacKnight said the nationally-recognized real estate appraiser conducted a review of the appraisals, and he identified 8 items that should have been addressed during a normal review. Mr. MacKnight said the state's

However, he said, the AG's Office strongly recommends, as did the Auditor's Office, that the Finance Cabinet should enforce an extensive review process, require records to be kept of the amount of time taken to review an appraisal, require that each step in the review process be documented, and safeguard records for future reference.

Chairman Damron asked whether the recommended changes would require statutory or regulatory changes, or policy changes within the Finance Cabinet. Mr. Cubine said each of the recommendations could be executed by administrative regulation, and would not require statutory changes.

Senator Green asked the names of the 3 partners in the Southcreek Properties Partnership, which owned half of the stock in the Southcreek Lexington Properties Corporation. Mr. MacKnight said the partners' names are Mr. Ted Hahn, Mr. Harold Mullis, and Mr. J. Pat Williams. Senator Green asked that the names be provided in writing.

Chairman Damron asked if the AG's Office had met with Finance Cabinet representatives to discuss the AG's recommended changes. Noting that the recommendations of the AG's Office were the same as those in the Auditor's report, Mr. Cubine said the AG's Office had had brief discussions with Finance Cabinet officials.

In response to questions from Representative Todd, Mr. MacKnight said there are a number of items in the appraisal that the City of Lexington and the state relied on that should have been caught in the state's appraisal review process. For instance, the value of the property was stated on the front page of the appraisal as \$6.9 million, but, based on interviews, the City of Lexington treated its value as \$7.3 million. According to interviews, he said, the City of Lexington arrived at the \$7.3 million figure based on a parenthetical notation in the appraisal that if the Ben Ali Garage were to have 2 floors added, the Garage would be worth \$400,000 more. He said investigators asked the appraiser if he intended for the 2 numbers to be added to come up with a total of \$7.3 million for the value of the property; the appraiser said if he had been asked, he would have said no. Mr. MacKnight said that is just one example, and there were 7 other mistakes. He said the AG's Office recommends that if the appraisal review process is thorough and enforced, this situation should be prevented from

and AG have come up with is a recommendation the state should change the way it does things. He said this situation bothers him a lot because it is so hard to find state dollars to help people who need it. He said the state should either get its money back or see something constructive built on the property.

Mr. MacKnight reiterated the Auditor's Office, according to its national expert, believes that a proper review would have picked up on the problems. Unfortunately, because the file is missing and neither the reviewer nor other officials can remember specifics, the AG is unable to determine exactly what happened in the review process. However, he said, the City of Lexington, according to his understanding, has filed a civil lawsuit against the appraisers which should address some of Representative Maggard's concerns.

Representative Maggard said it did not seem coincidental to him that, with all of the Finance Cabinet's files, that this particular file pertaining to a major expenditure of taxpayers' money is the one that is missing. He said he was interested to hear what action Finance officials will take to make sure this does not happen again; with computer technology, surely there is a way to ensure there will always be a file.

Senator Green asked if Mr. MacKnight could report on the status of the litigation filed by the Commonwealth against the Lexington-Fayette Urban County Government. Mr. MacKnight said the AG's Office is not involved in that litigation, but the Finance Cabinet's General Counsel could respond to the question.

Representative Todd asked who got the windfall when the state overpaid for the property. Mr. MacKnight said the Auditor's report details the distribution of the proceeds of the sale. The sale price was \$7.27 million, and \$6.48 million went to the Kentucky Central Life Insurance Company as the lender: \$5 million for return of principal and \$1.47 million for interest. Of the remainder of the \$7.27 million, \$627,000 was a tax obligation that the Southcreek Corporation had when it bought stock in the company that owned Ben Ali Garage. Mr. MacKnight said, based on an audit, that left about \$158,000 in profit for the Corporation. Chairman Damron said he thought that Kentucky Central also got part of the \$158,000 as the 50% partner in the Corporation. Mr. MacKnight said he was unsure how the \$158,000 was divided. Chairman Damron noted that the

downtown Lexington in the late 1980's, and realized a return of 11.5%. Chairman Damron said this was at a time when everyone recognized that there was a down market and that land values in downtown Lexington were depressed, as he believed was mentioned in one of the appraisals. Mr. MacKnight said he was sure the national expert, and he believed the 2 local appraisers, expressed the opinion that the market was flat.

Chairman Damron asked if the AG recommended that local governments be required to follow state procurement codes and requirements when acquiring real property on behalf of the state. Mr. Cubine said that, while he could not comment on this project's MOU because it is part of the state's lawsuit, MOUs generally have been of benefit to the state. Since the mid-1980's, MOUs have been increasingly used by the state in economic development projects. He noted that in the past, in some instances, the Commonwealth actually gave out grant funds without any written agreement, and from that perspective, the MOU is a positive development. However, he said, MOUs are now being used on a much broader scale; they are being used between Executive Branch agencies, and between Executive Branch agencies and external agencies such as local governments and quasi-governmental entities. He said they are being used to procure services, to transfer assets and real estate, to award grants and funds, for employment purposes, and for construction.

An issue that has come up, Mr. Cubine said, is where MOUs are to be filed. He said the Finance Secretary was a party to this particular agreement, but there are other MOUs being executed in state government involving millions of dollars on an annual basis to which the Finance Secretary is not a party. He said questions raised include: (1) who can obligate the Commonwealth; (2) is that obligation binding; (3) what are the terms and conditions being agreed to; (4) are the MOUs being used to avoid statutory requirements - such as an employment cap; and (5) if the Commonwealth is going to delegate its responsibility to a local entity, what laws should apply. He said throughout KRS Chapter 45A, there are references to the authority of the Finance Secretary to do specific things, but if the state delegates functions to local government, then who in fact becomes the Secretary of Finance - is it the head of the local government, the chief procurement officer, or the head of the fiscal court. He said all of these things need to be carefully laid out if the state in fact is going to delegate that sort of responsibility, and if in fact we are going to create a situation where one

people other than agency heads when the Secretary of Finance, under statute, is the only person who can actually obligate the Commonwealth.

Chairman Damron asked Mr. Cubine to meet with this Committee's staff and the Program Review Committee's staff over the next few days, to discuss whether statutory language is needed to address the use of MOUs. He said the broader use of MOUs may be a bigger issue, with far more state dollars involved, than the problems associated with the specific project being considered today. He said there apparently is a whole "underground" of agreements and contracts working between state and local entities that are not under the oversight or control of the Finance Cabinet as they should be. He said he thought this situation has evolved over time, and the General Assembly may need to address the issue.

Chairman Damron said that in July 1995 when the Committee received the State Auditor's report on the Ben Snyder block acquisition, the Committee was also told that the Finance and Administration Cabinet was conducting an internal review of its policies based on the Auditor's findings. He said he asked the Finance Cabinet to participate in today's meeting and to report on policy changes made as a result of the internal review. He said Karen Powell, the Finance Cabinet's General Counsel, and Rex Hunt, the Cabinet's Deputy Secretary, were present to report to the Committee, and he recognized Finance Secretary John McCarty. Secretary McCarty said Ms. Powell and Mr. Hunt have been working for 7-8 months on developing Finance Cabinet policy to address the recommendations in the Auditor's report. Secretary McCarty said he had to leave to attend another meeting, but would return to the Committee meeting as soon as possible. Chairman Damron said he wanted to publicly commend Secretary McCarty for his cooperation in working with the Committee since his appointment, and his speedy grasp of the many issues the Finance Cabinet is currently involved in, including the ongoing budget process.

Mr. Hunt said he hoped many of the concerns raised by the Cultural Center project can be resolved today. He said the World Trade and Cultural Center project undoubtedly pointed out some problems, but the Finance Cabinet feels the project was unique in the way it was handled and the way state moneys were turned over to the City of Lexington. He said most such projects are controlled directly by the Finance Cabinet, and he noted that compliance with KRS Chapter

which will now be incorporated into any MOU the Cabinet enters into with any local or other governmental agency that is doing construction in conjunction with the Cabinet.

Mr. Hunt said the Auditor's recommendations and resulting policy changes were timely, because the changes were immediately incorporated into 2 new major line-item economic development bond (EDB) projects - the new Northern Kentucky Convention Center and the Commonwealth Convention Center Expansion. He said the Finance Cabinet would not recommend any changes to KRS Chapter 45A itself; the problem is when local agencies participating in a project are not operating under the statute. He said the Cabinet would have no problem with requiring that any agency operating on behalf of the Finance Cabinet operate under procedures at least similar to Chapter 45A, but this requirement does not need to be made statutory. He assured the Committee that the Finance Cabinet definitely will enforce such a requirement in the future to provide the state that protection.

In response to questions from Chairman Damron, Mr. Hunt said the Finance Cabinet would enforce that requirement through a policy change rather than administrative regulation. Chairman Damron said the problem with agencies doing things by policy is that the policy can be changed later or by the next administration without the legislature being informed; if a policy is in the regulations, any changes would at least have to be reported to the legislature's Administrative Regulation Review Subcommittee. Mr. Hunt said the Finance Cabinet recognizes and understands that concern, and he expected Finance Cabinet staff and legislative committee staffs to continue working to further develop the new processes. He said major steps have been made, and while the process is not completely "cured," he does not recommend statutory changes now.

Ms. Powell said MOUs and MOAs (Memoranda of Agreement) are contracts, regardless of what they are called, as long as the terms are definite and concise and can be enforced by a court of law. For purposes of discussion, she said she would call agreements between the Finance Cabinet and other government entities concerning line-item construction projects Memoranda of Understanding. She said EDB pool projects have their own specific contract or agreement to provide funds, usually grants, to qualifying governmental agencies



over the project. She said the Finance Cabinet was very careful with the agreements for the 2 convention center projects more recently executed - local bonds are required to be issued by a specific date before state bonds are issued; a very detailed description is included of the project financing; ownership and responsibilities are spelled out. In addition, they provide that if any of the deadlines are not met, the agreements will be null and void, and the state will not be obligated to provide funds to the projects. She cautioned against statutory changes that would prevent the Finance Cabinet from taking advantage of innovations that might come up.

Ms. Powell said many of these changes will be formalized in the Finance Cabinet's policy manuals after the agency has determined how they will affect all types of projects. The Cabinet does not want to pinpoint specific requirements and then come across a different arrangement that is needed but will not be allowed because the Cabinet has narrowed its requirements.

Mr. Hunt said the agreements for the 2 convention center projects, as Ms. Powell explained, are detailed with specific deadlines for provision of local funding, and it is very clear in the agreements that the Finance and Administration Cabinet is in control of the projects. He said the Finance Cabinet does need flexibility in developing such agreements because each project will be unique. He said the Cabinet has already made changes in 8 specific areas to be incorporated in future agreements, and he can foresee the Cabinet making changes constantly to update the agreements. Ms. Powell said Louisville's Commonwealth Convention Center Expansion project is probably the best illustration of why the state needs flexibility in developing MOUs, because that project was so complex.

Chairman Damron said the problem with the Cultural Center project, as Representative Maggard said earlier, is that no one seems to be responsible. Mr. Hunt said he was not trying to shift the responsibility, but the most damaging aspects of the Auditor's report were directed at the Lexington-Fayette Urban County Government. He said the Finance Cabinet, however, should not have allowed control of the project to go elsewhere, and that is what the Cabinet is trying to avoid in the future. Chairman Damron said the public expects the Finance Cabinet to have oversight of state projects, and this Committee to have a level of oversight over the Finance Cabinet. He said that is why this Committee

later that day. She stated also that the suit by Lexington against the appraisers has been impleaded into the state's suit against the City of Lexington, so there is just one suit now, with the appraisers as third-party defendants. Chairman Damron asked if the Patton Administration will pursue repayment by Lexington of \$9 million for the state bond funds plus interest spent for the Ben Snyder block. Mr. Hunt said the lawsuit filed by former-Governor Brereton Jones is ongoing; he said he could not answer regarding the Patton Administration position regarding repayment by Lexington. He added that the new administration has had to deal immediately with many issues, including the biennial budget process.

Mr. Hunt asked Clark Beauchamp, Commissioner of Facilities Management, and Jim Abbott, Director, Division of Real Properties, to discuss changes underway to improve the Finance Cabinet's appraisal review process. Commissioner Beauchamp said the Finance Cabinet's internal auditors are looking at the process and working with Facilities Management staff to tighten it up. Mr. Abbott said there was no language in the Cultural Center MOU directing the appraisal process. He said the Division of Real Properties currently uses a very regimented, bureaucratic process for property appraisal. He said, in the effort to tighten up measures used in future MOUs or other projects handled by his office on a daily basis, the Division surveyed other states to see how they appraise property and determine fair market value. In addition, the Division conferred with other state agencies, primarily the Transportation Cabinet, to learn about their property appraisal process. He said guidelines for the appraisal process will be included in future MOUs involving projects like the Cultural Center.

Chairman Damron asked if Facilities Management has a certified appraiser on staff to review appraisals, noting the Department has staff architects and engineers to review project plans. Mr. Abbott said there is not a certified appraiser on staff. Commissioner Beauchamp said that definitely should be looked into; he said at one time there was a certified appraiser on staff, but it is very difficult to keep appraisers when they can go into the private sector and triple their income. He said the Department's former appraiser went through the entire appraisal training process at state expense, and once certified, left state government within 2 months. He said the Department has been more successful retaining architects and engineers because their potential private sector income is somewhat closer to what the state pays. In response to questions from

concern was whether such an appraiser would be able to appraise multi-million dollar properties.

In response to a question from Representative Wayne, Commissioner Beauchamp said that the state is probably the largest owner of real estate in the Commonwealth.

In response to questions from Representative Todd, Mr. Abbott said Real Properties has for some time required fee appraisers to follow the Appraisal Institute's guidelines; no such guidelines were provided to or required of Lexington or its appraisers for the Cultural Center project.

Chairman Damron asked if the state has a list of approved appraisers and whether the 2 Lexington appraisers were on the list. Commissioner Beauchamp said the state has such a list, and Mr. Cubine of the AG's Office indicated that both of the appraisers were on that list in 1988.

Chairman Damron asked if the new guidelines mentioned by Mr. Abbott are already in place. Mr. Abbott said the guidelines to be included in future MOUs are in place; the Finance Cabinet is now looking to enhance the appraisal review process. Chairman Damron asked that information be provided to Committee staff on that enhanced review process when it is ready. Chairman Damron said he thinks the Committee understands that any appraisal is just one person's opinion, and hindsight is 20/20; he said in fairness to the 2 appraisers, it is much easier to appraise property 5 years later and conclude it was overvalued by \$3 million than at the earlier date.

Chairman Damron asked whether, in Commissioner Beauchamp's and Mr. Abbott's opinion, the state is doing everything it can do to make sure this situation does not happen again, and if not, what else would they recommend that the Committee consider. Mr. Abbott said the Finance Cabinet is making a commitment to make sure the situation does not recur. Commissioner Beauchamp said he believed that the state will be in a much better position than it has been, and he thought the probability of this happening again would be very low.

In other business, Chairman Damron noted the Committee's review last

Chairman Damron said the Committee's next regular monthly business meeting was scheduled for Wednesday, February 28, at 1:00 p.m. in Room 113. There being no further business to come before the Committee, the meeting was adjourned at 1:45 p.m.